WILLIAM F. YOUNG
E-MAIL: BYOUNG@HUNTON.COM

FILE NO.: 55430.000001
DIRECT DIAL: (202) 955-1684

March 27, 2000

By Hand

The Honorable David P. Boergers
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

Request of New York Independent System Operator, Inc.
for Suspension of Market-Based Pricing
for 10-Minute Reserves and to Shorten Notice Period

Dear Mr. Boergers:

Pursuant to Section 205 of the Federal Power Act, 16 U.S.C. § 824d (1999), and Section 35.13 of the Commission's Rules of Practice and Procedure, the New York Independent System Operator, Inc. ("NYISO"), by counsel, hereby seeks immediate authority, effective March 28, to suspend the use of market-based bids in the New York markets for 10-minute reserves, until those markets can be demonstrated to be workably competitive. Specifically, the NYISO requests authority to revise Rate Schedule 4 of its Market Administration and Control Area Services Tariff ("ISO Services Tariff") to require that all bids for 10-minute reserves be cost-based until the 10-minute reserves markets are modified to be workably competitive, with any such modifications subject to review by the Commission.[1] Such authority is essential in the face of substantial evidence that the levels

[1] The NYISO is seeking an amendment to the ISO Services Tariff under Section 205 of the FPA pursuant to the provisions of Section 19.01 of the Agreement Between New York Independent System Operator and Transmission Owners. Section 19.01 provides that the NYISO Board may submit a

of bids and quantities offered, and the resulting prices, for 10-minute reserves have deviated substantially from the market conduct and outcomes that would be expected if the 10-minute reserves markets were workably competitive.

In addition, the NYISO requests the implementation of a settlement process, in accordance with the Commission's alternate dispute resolution procedures, under the auspices of the Commission and with the participation of the New York Public Service Commission ("NYPSC"). The purpose of the settlement process would be to bring together all buyers and sellers of 10-minute reserves in order to reach a resolution by agreement on whether the pricing for 10-minute reserves has been at proper levels and, if not, whether any overpayments for reserves should be refunded to (or not paid by) the loads. In furtherance of this settlement process, the NYISO requests authority not to bill or collect for apparent overcharges for 10-minute reserves during the period March 1, 2000 through the effective date, which the NYISO has requested be March 28, of the bid limits specified herein.

<u>Documents Submitted</u>

1. This filing letter;

2. Chart titled: "10-Minute NSR Clearing Prices and Offers less than $30 per MW: Daily Averages for January 1 to March 21" (Attachment A);

3. Chart titled: "Average Daily Price of 10-Minute Reserves: Day-Ahead Market (11/22/99 - 3/17/00" (Attachment B);

4. Chart titled: "Total Daily Reserves Costs; 12/1/99 to 3/22/00" (Attachment C);

5. Revised tariff sheets, in redlined and clean versions (Attachment D);

(..continued)
proposed amendment to the ISO Services Tariff without the concurrence of the Management Committee if the ISO Board certifies that "(1) the proposed amendment is necessary to address exigent circumstances related to the reliability of the NYS Power System or to address exigent circumstances related to an ISO Administered Market; and (2) the urgency of the situation justifies a deviation from the normal ISO governance procedures." The NYISO will promptly seek the concurrence of the Management Committee, and will ask the appropriate committees of the market participants to review and analyze the structure and performance of both markets to determine how they can be made workably competitive as soon as possible.

6. Affidavit of David B. Patton, NYISO Market Advisor (Attachment E);

7. Affidavit of James H. Savitt, NYISO Manager of Market Monitoring (Attachment F);

. 8. Form of *Federal Register* Notice (Attachment G).

Copies of Correspondence

John P. Buechler
Director, Regulatory Affairs
New York Independent System Operator, Inc
3890 Carman Road
Schenectady, NY 12303
Tel: (518) 356-6153
Fax: (518) 356-4702
Jbuechler@nyiso.com

Arnold H. Quint
William F. Young
Hunton & Williams
1900 K Street, NW, Suite 1200
Washington, DC 20006-1109
Tel: (202) 955-1684
Fax: (202) 778-2201
byoung@hunton.com

Historical Background

In its Order Accepting for Filing in Part and Rejecting in Part Market Monitoring and Mitigation Plan, Subject to Modifications ("MMP Order"), issued November 23, 1999, *New York Independent System Operator, Inc.*, 89 FERC ¶ 61,196 (1999), the Commission accepted in part and rejected in part the market monitoring plan and mitigation measures filed by the NYISO on July 26, 1999 and August 23, 1999. The MMP Order directed the NYISO to file a revised plan and mitigation measures modified as required by the MMP Order. That filing was made on December 23, 1999. The MMP Order states that acceptable revised mitigation measures could commit the NYISO to make filings with the Commission under Section 205 on a case-by-case basis requesting authorization to impose specific mitigation measures when the NYISO concludes such measures are warranted. 89 FERC at 61,605. This filing adopts this approach.

This filing has the support of David Patton, who is the NYISO's independent Market Advisor and who prepared certain of the supporting exhibits attached hereto.

Description of the
10-Minute Reserves Requirements and Concentration of the Market

A critical component of the markets for 10-minute reserves in New York is the market for 10-Minute Non-Synchronized Reserves ("10-Minute NSR" or "NSR"). 10-Minute NSR are described in Rate Schedule 4 to the ISO Services Tariff and specifically in Section 3.0 thereof. The market for 10-Minute NSR has clearly not been functioning as a competitive market.

In order to meet applicable reliability standards, a total 10-minute reserve requirement of 1200 MW has been established for the New York Control Area ("NYCA"). Of this amount, at least 600 MW must be spinning reserves ("10-Minute SR"). The balance of the 10 minute reserves may be 10-Minute NSR. 10-Minute NSR is generally supplied by "quick-start" turbines, that is, turbines that are not turned on but that can be up and running within 10 minutes. Although there is a limit on how much 10-Minute NSR can be used to meet the 1200 MW requirement, there is no such limit on spinning reserve purchases – *i.e*., all 1200 MW reserve purchases by the NYISO could be spinning reserves, since these are generally considered to be a higher quality form of reserves than NSR. For this reason, under normal conditions 10-Minute NSR prices would be expected generally to be somewhat lower than 10-Minute SR prices, a difference reinforced by the requirement that the ISO must purchase more expensive spinning reserves to meet the 600 MW spinning reserve requirement.

On the other hand, if the price for 10-Minute NSR is bid up above the normal pricing levels for 10-Minute SR, the price for 10-Minute NSR should set the clearing price for both types of reserves. This is because spinning reserves are superior quality reserves by comparison to non-spinning reserves, and thus spinning reserves should not be valued at anything less than the value of NSR. This relationship was recognized by the Commission in its January 27, 1999 Order accepting the proposed market rules of the NYISO. *See Central Hudson,* 86 FERC ¶61,062 at 61,227; *see also* Section 4.9 of the ISO Services Tariff (stating that "The ISO will select the least cost mix of Ancillary Services and Energy Suppliers. The ISO may substitute higher quality Ancillary Services (*i.e.,* shorter response time) for lower quality Ancillary Services when doing so would result in an overall least cost solution. For example, 10-Minute Non-Synchronized Reserve may be substituted for 30-Minute Reserve if doing so would reduce the total cost of providing Energy and Ancillary Services.").

There is a locational requirement for reserve purchases that significantly affects the market for 10-minute reserves. To maintain reliable service, under the generally prevailing system conditions all 1200 MW of the total 10-minute reserves requirement (spinning and non-synchronous) must be purchased east of New York's Central-East constraint. Roughly half of the state's spinning reserve capability is west of this constraint. Absent this constraint, spinning reserves from the west would be an alternative to the purchase of 10-Minute NSR in the area east of Central-East. The existence of this constraint, however, severely limits the quantity of spinning reserves that western suppliers can contribute to the state's total requirement. There are also locational requirements for minimum purchases of 10-minute reserves on Long Island, but these constraints have generally not been binding.

The 10-Minute NSR capacity in New York is owned by five entities, with Keyspan-Ravenswood, Inc., LIPA and NRG Power Marketing, Inc., together accounting for 97% of this capacity. The table below shows the ownership shares for 10-Minute NSR capability:

Ownership Shares of 10-Minute Non-Synchronized Reserves *

	Total Capability	***Share***
LIPA	1317	56%
NRG Power Marketing Inc.	533	23%
KeySpan- Ravenswood, Inc.	446	19%
Central Hudson Gas & Electric Corp.	44	2%
Rochester Gas & Electric Corp.	19	1%
All Owners	2359	

* 10-Minute NSR capability is affected by ambient temperatures. The figures shown are the winter ratings provided by the specified owners for their 10-Minute NSR units. The summer capability figures are between 80% to 90% of the winter figures, with the total summer capability being 1967 MW or 83.4% of the winter capability.

The Hirschman-Herfindahl Index ("HHI") of market concentration for a market with the shares shown above would be 4,031. Under the Commission's *Merger Policy Statement*, a market with an HHI at that level would be deemed highly concentrated. *Inquiry Concerning the Commission's*

Merger Policy under the Federal Power Act: Policy Statement, FERC Stats. & Regs., Regulations Preambles, ¶ 31,044 at 30,129 (1996).

The Nature and Effect of Reserves Bidding Patterns

Prior to January 29, on average more than 1400 MW of 10-Minute NSR was being offered. On January 29, the quantity being offered dropped below 900 MW, or less than 40% of the total of 2359 MW of non-synchronous capability, and remained below the prior average levels for the remainder of the period giving rise to this filing. In addition to this physical withholding, the offer prices for non-synchronous reserves rose substantially during the same time period. Thus, the decrease in quantities effectively being offered to the market was even more dramatic when the prices at which 10-Minute NSR was being offered are taken into account, as shown on Attachment A. Prior to January 29, the 10-Minute NSR market cleared at between $0 and $2.52 (with the exception of one hour when the price was set by a 30 minute reserves unit). Thereafter, the quantity of 10-Minute NSR being offered at less than $30 dropped from a high of over 1200 MW prior to January 29 to a subsequent low of only just over 300 MW, for a decline of approximately 75%. After January 29, the quantity offered at less than $30 was frequently below 400 MW or less, and went back up over 500 MW only after March 10 and even then went above 600 MW on only four days. Of course, the $30 price selected here for illustration was more than 10 times higher than the previous maximum market clearing price. This decline in the quantity offered, and the resulting price effects discussed below, constitute bidding patterns that would significantly exceed the levels for both physical and economic withholding that have been proposed by the NYISO as thresholds for the imposition of Market Mitigation Measures.

Attachment A also correlates the amount of 10-Minute NSR effectively being offered to the resulting price. When the amount offered suddenly declined and the offer prices rose, not surprisingly the price in the market jumped. On February 12, 2000, the average daily price for 10-Minute NSR peaked at $124.80. *See* Attachment B. On February 13, the hourly price for 10-Minute NSR peaked at $302. In February 2000, the mean price for NSR was $65.57, as compared to a mean for

November 1999 of $1.04, and a mean for December 1999 of $1.06. See attached affidavit of Dr. James H. Savitt, NYISO Manager of Market Monitoring.

When the price for 10-Minute NSR rose dramatically, the NYISO employed its "cascading" policy for reserves by increasing its purchases of 10-Minute SR above the 600 MW minimum when it was less expensive to do so than to purchase 10-Minute NSR. As noted above, under NYISO market rules, when this becomes necessary because the price for 10-Minute NSR exceeds the marginal offer price for 10-Minute SR, the price for 10-Minute NSR sets the market clearing price in both 10-minute reserves markets. The result has been that the non-competitive prices in the 10-Minute NSR market have had the effect of raising prices for *all* 10-minute reserves, with both spinning and non-synchronous 10-minute reserves priced at the same elevated clearing price. This can be seen in the charted pricing data for the relevant period attached hereto as Attachment B. As indicated by this chart, for the 24 highest priced days for 10-Minute NSR the same price prevailed for 10-Minute SR (except for one day, when the spinning reserves price was about $3.00 higher than the NSR price).

Attachment C shows the total daily costs for reserves incurred by the NYISO for the period from December 1, 1999 to March 22, 2000. From a daily level generally well below $1,000,000 in December, the daily cost for reserves peaked at over $7,000,000 in February. The total cost for reserves for December were $6.5 million; in February, the total cost for reserves climbed to almost $75 million.

In a further analysis of the effects of the 10-Minute NSR bidding described above, the NYISO Market Advisor, David Patton, substituted for the actual offers for 10-Minute NSR a set of reference values equal to each unit's average offer quantity and price up to January 29. In other words, the Market Advisor assumed that each seller continued to offer 10-Minute NSR from its units as it had prior to January 29. *See* Attached Affidavit of David B. Patton, NYISO Market Advisor. The Market Advisor's analysis is very conservative, because it does not account for the fact that when 10-Minute NSR become less expensive, it will tend to displace more expensive spinning reserves purchased above the 600 MW purchase requirement. Since the Market Advisor evaluated the mitigated prices by assuming the same level of 10-Minute NSR and 10-Minute SR as actually occurred, the additional savings available by purchasing more 10-Minute NSR are not included. Given this mitigated supply curve for 10-Minute NSR, the Market Advisor then calculated proxy competitive clearing prices in each market. This analysis shows that for the period from January 29 to March 10:

- the total costs of 10-Minute NSR increased from an estimated mitigated level of $1.4 million to more than $44 million;
- the total costs of 10-Minute SR rose by more than $22 million;
- the total costs to the load serving entities purchasing 10-minute reserves through the NYISO rose by approximately $65 million;
- revenues of individual sellers in both 10-minute reserve markets rose by as much as $25 million; and
- individual sellers' profits, computed as the difference between sales in the 10-minute reserve markets minus obligation to pay for all reserves (including 30-minute reserves), increased as much as $15.5 million.

Comparison to other markets demonstrates the dramatic impact of the lack of competitive performance in the 10-Minute NSR market. The cost of reserves as a percent of energy costs in other markets, including the New York markets prior to February, 2000, has ranged from roughly two to five percent. For example, the *1999 Year End Summary of Market Performance* of the California ISO indicates that the most recent experience in that market has been that the cost of *all* ancillary services has been at about 5.6% of total market energy costs. Since the change in bidding patterns described above, in New York the costs of 10-minute reserves alone have jumped to between 20% and 30% of total energy costs.

<u>Description of Tariff Changes and Other Requests</u>

The NYISO requests authority to take the following actions in order to prevent continuation of the non-competitive performance of the 10-minute reserves markets.

First, starting March 28 and continuing until such time as it can be determined that the markets for 10-Minute SR and 10-Minute NSR are workably competitive, the NYISO requests authorization to require *all* units east of the Central-East constraint that are capable of providing reserves, and that are not subject to a *bona fide* outage or conflicting contractual obligations (including contracts under PURPA), to bid into the appropriate 10-Minute SR or 10-Minute NSR market, and the NYISO further requests authorization to limit bids for spinning and non-synchronized 10-minute reserves to cost-based levels as specified below. These requirements are clearly warranted for the 10-Minute NSR market, in light of its very high level of concentration, the failure to offer capacity into that market, and the market's consequent non-competitive performance. In addition, because of the relationship in the price performance of the two markets, for the time being it is necessary to implement these measures for both types of reserves, in order to preclude unanticipated consequences for spinning reserves from the implementation of cost-based bidding for non-synchronous reserves.

In order to implement the foregoing requirements in an expeditious and equitable manner, the NYISO requests that offers for 10-Minute NSR from units east of Central-East be subject to a cost-based limit equal to the incremental cost of providing non-synchronized reserves, but not to exceed $2.52 per MW per hour. This price is the highest market clearing price (with the exception of one hour when the price was set by a 30 minute reserves unit) for 10-Minute NSR in the period from the start of the 10-Minute NSR market to the time when the bidding and pricing described above started to occur. *See* Affidavit of James H. Savitt. During that period, the lowest market clearing price for 10-Minute NSR was zero. *Id.* Since the incremental costs of providing 10-Minute NSR should be quite low, and since $2.52 was the highest market clearing price observed during the period when the market appeared to be functioning normally, using this as an upward limit on incremental cost bids should ensure that sellers are adequately compensated, while avoiding lengthy proceedings to determine a unit's actual incremental costs.

With respect to 10-Minute SR, the NYISO requests authorization to require all units east of the Central-East constraint that are capable of providing 10-Minute SR to offer to provide 10-Minute SR at $0, plus the verifiable fuel commitment costs for providing 10-Minute SR. Under the NYISO

Services Tariff, a unit providing 10-Minute SR will be paid its lost opportunity cost, if any, in the real-time market. Thus, under the foregoing proposal sellers will be made whole for their costs of providing 10-Minute SR. This remedy for 10-Minute SR is consistent with the approach approved by the Commission in its Order Accepting Market Power Mitigation Measures, as Modified, for Filing, in *Consolidated Edison Company of New York, Inc.*, 84 FERC ¶ 61,287 (1998).

As soon as it can be determined that either of the 10-minute reserves markets can function in a workably competitive manner, the NYISO will seek the removal of the cost-based limit for bids into that market. To that end, in conjunction with seeking this mitigation measure the NYISO is requesting the appropriate committees of the Market Participants to review and analyze the structure and performance of both markets, and to determine how both can be made workably competitive as quickly as possible. In addition, the NYISO is currently in the process of determining whether any of its procedures may have been unnecessarily limiting participation of any units in the 10-Minute SR market, and is hopeful that it may be possible to restore market-based bidding in at least the 10-Minute SR market relatively quickly. Any proposed modifications to either of the 10-minute reserves markets resulting from the foregoing processes will be submitted to the NYISO Board and the Commission for approval.

Second, effective March 1 the NYISO requests authorization to bill and collect for 10-minute reserves for the period March 1, 2000 through the effective date of the bid limitations, which the NYISO has requested be March 28, based on a *pro forma* approximation of the prices that would be expected to result from a workably competitive market, pending the outcome of the settlement process described below. In the ordinary course, billing for this period will be completed in mid April (billing and collection for prior periods has already been completed). In order to do this in a manner that can be readily determined and implemented, the NYISO would propose to make the *pro forma* calculation on the basis of the weighted average 10-minute reserve prices prevailing in the period prior to the dramatic increases in prices described above. While this *pro forma* determination may delay payment to sellers of some revenues to which they may believe themselves entitled, it is equally true that billing and collecting on the basis of the recently observed prices for 10-minute reserves would impose significant costs on load serving entities that they believe they should have no obligation to pay. Because of the substantial basis for concern about the competitiveness of the 10-minute reserves markets described above, and because the billing and collection for a substantial portion of the price run-up period has already been conducted on the basis of the high prices experienced in the 10-minute reserves markets, the NYISO believes that the equities strongly favor the proposed *pro forma* billing and collection.

Third, The NYISO requests that the Commission initiate a settlement process facilitated by its Dispute Resolution Service ("DRS"), under procedures that will protect the confidentiality of competitively sensitive information. The NYISO believes that a settlement process involving the relevant parties will be the best method of resolving the issues and disputes arising from the pricing patterns described above. The parties to the settlement process should be directed to negotiate in good faith toward a resolution of the appropriate amounts that should be billed and collected for 10-minute reserves for the period January 29, 2000 to the effective date of the bid limits, which the NYISO has requested be March 28.

The NYISO requests that the settlement process be structured along the following lines:

- The parties to the proceeding should include all buyers and sellers in the New York markets for 10-minute reserves;

- The settlement process should be under the auspices of the Commission's DRS Office and include the participation of the New York Public Service Commission ("NYPSC"), with the representatives of the Commission and the NYPSC proposing procedures and schedules appropriate for prompt and equitable resolution of the process and for protection of commercially sensitive information; and

- The settlement process should conclude in 90 days.

The NYISO has discussed its proposal for a settlement process along the foregoing lines with the NYPSC, and understands that the NYPSC would strongly support this proposal and stands ready to be an active participant in the process. A similar cooperative effort by the Commission and the NYPSC to facilitate negotiation and consensus among the interested parties was extremely beneficial in the development of the NYISO's governance procedures, and the NYISO believes the same would be true here.

If no reconciliation of the parties is reached in the settlement process, the NYISO requests authorization to make a final determination of prices for 10-minute reserves for the period from January 29 through the effective date of the bid limits, which the NYISO has requested be March 28, on such basis as may be ordered by the Commission upon review of a proposed methodology to be submitted by the NYISO not later than 30 days after the conclusion of the settlement process. With the expectation that the settlement process will be successful, the NYISO requests that a determination on the need for retroactive implementation of this request be deferred to the Commission's review of such supplemental filing, if any. If prices in the 10-minute reserve markets were not determined by competitive market forces, a redetermination of those prices to just and reasonable levels would be appropriate. *Compare Washington Water Power Company*, 83 FERC ¶ 61,282, at 62,169 (1998) (requiring a refund of profits in connection with transactions undertaken in violation of utility's market-based rate order and affiliate conduct requirements); *Iowa Southern Utilities Co.*, 58 FERC ¶ 61,317, at 62,013 (1992) (requiring a refund of an unduly discriminatory difference in rates offered to unaffiliated customer over rate offered to affiliated customer); *Transcontinental Gas Pipe Line Corp*., 52 FERC ¶ 61,248, at 61,855-856 (upholding ALJ decision requiring pipeline to refund profits realized on transportation of gas that was sold under conditions that were unduly discriminatory).

Effective Date and Request for Waiver of Notice Requirements

The NYISO requests effective dates for this filing as described above with respect to each requested action by the Commission, and requests waiver of the Commission's notice requirements as needed.

Waiver of the Commission's notice is especially appropriate here. The inability of market forces to mitigate the extreme rise in the price for 10-Minute NSR, and the consequent effects on 10-Minute SR, has only recently become apparent. After discovering the problem and conducting a sufficient investigation to determine the nature, extent and causes of the price increases, the NYISO has worked as rapidly as possible to document its findings, to consult with affected Market Participants in an effort to restore competitive conditions, to advise the NYISO Board, the Staff of the Commission and governmental officials in New York of developments, and to prepare this filing.

As described above, the NYISO is requesting authorization to take certain actions with retroactive effect. The Commission will allow a retroactive effective date when "extraordinary circumstances" are present. *See, e.g. Central Hudson Gas & Electric Corp., et. al*., 60 FERC ¶ 61,106 at 61,339 (FERC will not allow retroactive effective dates absent extraordinary circumstances)*; order on* reh'g, 61 FERC ¶ 61,089 (1992). Retroactive effective dates do not constitute impermissible retroactive ratemaking, or violate the filed rate doctrine. *See, e.g., Niagara Mohawk Power Corp.,* 44 FERC ¶ 61,243 at 61,880-81 and n.11 (1988). FERC's allowance of retroactive effective dates has also been upheld by the courts. *See, e.g., City of Piqua v. FERC*, 610 F. 2d 950, 955 (D.C. Cir. 1979); *Towns of Concord and Wellsley , Mass. v. FERC*, 844 F. 2d 891 (1st Cir. 1988). Here, the need to mitigate the extraordinary and non-competitive increases in prices of 10-minute reserves warrants the requested retroactive actions.

Federal Register Notice and
Request for Shortened Notice Period

Because of the extreme circumstances presented here, the NYISO requests that the Commission immediately issue notice of this filing and reduce the notice period to the minimum length of time possible. A draft *Federal Register* Notice is attached. Additionally, an electronic version in WordPerfect 5.1 format of the Notice is being furnished with this filing.

Copies of this filing are being served on all of the parties in Docket No. ER97-1523-000, OA97-470-000 and ER97-4234-000, not consolidated, and on all of those parties who have executed Service Agreements under the ISO OATT and the ISO Services Tariff.

Respectfully submitted,

Arnold H. Quint
William F. Young
Counsel for
New York Independent System Operator, Inc.

Attachments

Attachment A

Attachment B

Attachment C

Attachment D

Revised Tariff Sheets
(clean version)

Attachment E

Attachment F

Attachment G